UNIVERSITY OF PENNSYLVANIA

THE ECONOMIC EFFECT OF BLUE SKY LAWS

FORREST BEE ASHBY

A THESIS

IN ECONOMICS

PRESENTED TO THE FACULTY OF THE GRADUATE SCHOOL IN
PARTIAL FULFILLMENT OF THE REQUIREMENTS FOR
THE DEGREE OF DOCTOR OF PHILOSOPHY

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I

TYPES OF SECURITIES AND THE METHODS OF THEIR DISTRIBUTION

The simplest conceivable form of financial enterprise is that in which an individual risks his own funds in a business venture. In modern practice, however, new enterprises must rely for financing upon persons other than the originator of the project. These persons usually are not conversant with the industry in which they invest. They must be attracted to the proposition, and so the professional corporate promoter enters. He assembles the component parts of the project, employs technical experts, analyzes the profitableness of the scheme, capitalizes it, and sells the shares to investors or speculators. In the case of established corporations which believe expansion to be desirable but impossible of attainment through reinvested earnings, appeals must also be made to investors or speculators for funds. Thus originate the innumerable issues of stocks and bonds which now exist as the outstanding obligations of industrial and commercial corporations.

These stocks and bonds may be distributed by any one of several methods. In the first place, the corporation (either new or established) may market its securities by dealing directly with the public. This method has been adopted by many public utilities with considerable success, the companies in many cases maintaining regular sales organizations and appealing particularly to employes and customers. Issues of small corporations are commonly sold directly to local buyers. This method is also used by itinerant vendors of fraudulent securities. The great bulk (probably nine-tenths) of corporate securities are marketed, however, through investment bankers who organize underwriting syndicates, take over the issues of stock or bonds, and dispose of them to the public through sub-syndicates and their correspondents.

The stocks, bonds and other obligations which are issued by industrial and commercial corporations and other borrowers fall generally into one of four classes, which are commonly delimited somewhat as follows: First should be noted those securities ordinarily designated as gilt-edged investments, that is, bonds of stable governments, railroad bonds of senior or underlying issues, municipal debentures and other similar obligations, all characterized by low interest yields and wide margins of safety. Second come the

so-called business man's investments, illustrations of which are the dividend-paying stocks of established corporations, many real estate mortgage bonds as at present issued, most foreign government bonds, and other securities of like nature, all characterized by a fair interest yield, moderate margins of safety, and some speculative possibilities. The third class is composed of speculative securities, well illustrated by the shares of non-dividend-paying corporations and the securities issued by new enterprises which are in good repute and apparently are founded to occupy recognized business fields. The fourth and last class of securities comprises those issues which fall beyond the borders of honest risk into the vast and murky field of fraudulent flotations or issues, illustrated by the worthless stocks and bonds of the Templar Motors Company, the Hawkins Mortgage Company, the Commonwealth Hotel Company and many other swindling corporations, and all characterized by specious promises of fabulous returns, impossible risks and dishonest management.

The purchasers of these various classes of securities may also be classified in the light of their predominant characteristics and attributes into four general groups. The first class of securities purchasers may be said to comprise very wealthy persons, persons or institutions who are trustees for the funds of others, and that class of investors vaguely designated as "widows and orphans." All the investors in this class are (or should be) in search of securities which have, above all else, a wide margin of safety. It is (or should be) their endeavor to conserve the principal of their capital, and combined with the wide margin of safety which this purpose requires will almost certainly be found a low percentage of interest yield. Consequently the conclusion is unavoidable that this first class of investors forms a natural market for the first class of securities described above as gilt-edged investments.

A second class of securities purchasers may be described as consisting of persons having a general knowledge of past, present and future business conditions, the financial ability to accept capital losses from time to time, and the acumen to reinvest investment profits. These attributes are presumably characteristic of a great body of Americans rather loosely defined as "business men," who are consequently justified in seeking in their securities purchases for an interest yield, under present conditions, of from five to eight per cent per annum, combined with a moderate margin of safety and a prospect of some speculative profits. The capacities

and desires of this second class of investors render them a natural market for the second class of securities described above as "business men's" investments.

The third class of buyers of stocks and bonds may be said to include men who are (or should be) possessed of wide experience in one or more of the business world's spheres of activity, who are able to appraise the future possibilities of industrial and commercial enterprises, whether new or established, and who through their purchases of securities can divert a flow of capital funds into those economic fields which will yield the greatest profit both to enterprisers therein and to society. These men must be able, both financially and psychologically, to withstand losses of capital, they must understand the amortization of these losses through the reinvestment of large profits, and, because of their peculiar talents and attributes, they may be described as speculators, in the best sense of the word. This third class of securities buyers forms the proper market for the third class of securities described above as speculative obligations.

The fourth class of securities buyers is that congregation of financially dim-witted human beings who have neither business vision nor experience in financial affairs, but who are characterized rather by the attributes of avariciousness and a pronounced gambling proclivity, and who consequently fall a prey to the financial snares set about their willing feet by numerous perpetrators of financial jobbery and manipulators of worthless stocks and bonds. The number of persons falling within this class of securities purchasers is legion, and, in the vernacular of the securities world, they are dubbed "suckers." They form the market for fraudulent corporate obligations.

In considering the relationships existing between the foregoing classes of securities and securities purchasers, the social groups interested in their accouplement may be listed as: 1. the public; 2. issuers of securities; 3. underwriters and dealers in securities; 4. financial swindlers, and 5. investors themselves. Finally, as introductory to a discussion of the economic efferts of blue sky laws as at present administered, there must be noted three fundamental requirements for business progress, as follows: First, the replacement of worn-out capital in established economic pursuits; second, the provisions of capital for new, and hence hazardous, business fields; and third, the maintenance of market places where transactions connected with capital funds may be consummated.

The issue and sale of stocks and bonds occurs in the process of satisfying the first two requirements, which process necessitates the satisfaction of the third requirement.

The following discussion represents an endeavor to analyze the present blue sky laws, and to reach definite conclusions as to their effects, as at present administered, within the economic sphere as above delimited.

II

TYPES AND CLASSES OF BLUE SKY LAWS

Broadly speaking, there are at the present time two major types of American securities statutes (of which the second type may be divided into two main classes), as follows:

Type 1. Fraud acts;

Type 2. Regulatory acts, which comprise:

1. Statutes primarily supervising dealers[1] through licenses,[2] but also granting to issuers[3] permits[4] to sell their individual issues of securities. Statutes of this class are the so-called "dealer-licensing" acts.
2. Acts regulating each individual issue of securities through specific approval by the state commissions. Statutes of this class are the so-called "specific-approval" acts.

The fundamental principal back of the first type of securities legislation, namely, fraud acts, is to follow and punish the securities swindler under fraud acts and the common law and to abate the ardor of his brothers-in-crime through fear. The second type of securities legislation (regulatory laws) comprises, first, the class of "dealer-licensing" acts, which endeavor to prevent fraud by restricting the securities traffic to carefully selected professional dealers and individual issuers and revoking their licenses or specific permits, respectively, if imposition is discovered; and secondly, the class of "specific-approval" acts, which regulate the securities themselves, and seek to control each individual issue through specific permits of some kind. Both fraud acts and regulatory statutes come under the term of blue sky laws.[5]

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1. A dealer may be defined as one selling for his own account securities issued by another.

2. A license may be defined as an authorization (renewable annually) empowering a dealer to traffic in divers securities.

3. An issuer may be defined as one who obligates himself by the issue of securities, contracts or pledges.

4. A permit may be defined as permission to sell one specific issue of securities.

5. The one American act which in any way resembles the informative and punitive statutes of Europe is the Colorado law, which provided that,

This chapter is devoted to a description of these various types and classes of blue sky laws, including, first, a discussion of fraud acts; second, a consideration of the elements found in the typical regulatory statute; and third, a discussion of the several well-defined classes of blue sky laws of the regulatory type which have arisen as the different methods of regulating securities transactions have been variously emphasized by the states.

Fraud Laws

Fraud laws as a type of blue sky legislation are to be found upon the statute-books of three states, New York, New Jersey and Maryland. These acts apply to the issuance and sale of securities the principles of the criminal law which apply to fraud in general. There is no attempt at supervision before issuance or sale of securities, but injunctions are sought (or orders issued) to check suspicious transactions, while criminal prosecutions are waged against swindlers.

The fraud act type of securities legislation has been most completely developed in New York. The Martin fraud act (article 23a of the General Business Law of New York) was passed in May, 1921, but the measure lay dormant until the summer of 1923. It empowered the attorney general (or his deputy) to investigate the activities and operations of any individual or organization engaged in suspicious securities transactions, to subpoena witnesses and records in order to carry out such investigations, and, pending the bringing of a criminal action for fraud where it was discovered, to secure from the Supreme Court an injunction against the further sale of the securities under suspicion;[6] further, the attorney general was empowered to require foreign corporations offering their securities for sale within the state without having designated a resident agent to receive service of process, to furnish information as to

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before certain kinds of speculative issues may be sold, the issuer must file with the secretary of state a detailed prospectus stating the names of its directors and officers (if a corporation), the nature of its business, the details of its capital account, cash or securities paid or payable for promotion and preliminary expenses, tangible and intangible property, and commissions. Misrepresentations render the issuer, signers of the statement and sellers with knowledge liable to purchasers in damages.

6. A prominent member of the Baltimore bar considers the New York law superior to the New Jersey and Maryland fraud acts because the attorney generals of the two latter states have power to rule upon cases and issue orders and appeal is to the courts, while in New York the courts have "original jurisdiction."

the securities offered. Failure to comply with this latter provision might form the basis for an injunction against the foreign corporation. The Martin law was amended in 1925 by the Webb-Phelps act, which provided that:

1. Each securities dealer in the state should publish in an official paper a notice of his entry into the business of selling securities.
2. As each issue is offered, the seller must publish in the official paper:
    1. Information as in (1) above;
    2. The name of the security;
    3. The name of the issuer;
    4. The address of the issuer and the state or county in which it is organized.

The present New Jersey and Maryland fraud acts, both passed in 1920, provided that if fraud is suspected in the flotation of any issue of securities, or in any securities, or in any securities transactions, the attorney general of the state may require the issuer or dealer to present reassuring information, and, if fraud is evident, issue a restraining order to prohibit further sale of the tainted issue. This order is reviewable by the courts. No provision is made for the filing by the vendor of securities of any notice of intention to offer, as is required in New York under the Webb-Phelps amendment. Criminal actions are brought against fraudulent issuers and dealers.

Regulatory Laws

Regulatory securities statutes, comprising the second type of American securities legislation and depending for their effectiveness not upon an *ex post facto* consideration of issues or sales but upon supervision of dealers, agents and/or issues of securities prior to any selling or issuing, have been enacted in forty-two states,[7] their most complete development taking place in the Middle West. The following paragraphs explain the basic elements of the typical regulatory statute.

7. Including the Connecticut act, regulating only oil and mining issues.

The typical regulatory blue sky law contains a clause which may be thus expressed: "No sale of a security shall be effected in this state without permission of the securities commission," and by the force of this clause all securities, legitimate and illegitimate, deserving and undeserving, are lumped together, the law building a barrier against all in order that none may pass. However, it is not practicable to bar all unapproved transactions in credit instruments, as to do so would halt all industry and cause the decay of economic activities, and consequently succeeding clauses in the law reduce the primary application of the statute by writing into it certain exemptions and modifications.

Second, then, the typical blue sky law of the regulatory type contains a list of securities and transactions to which the act shall not apply, such as government bonds and issues of regulated public utilities, or sales by or to banks. These are the much-discussed "exemptions," which comprise a group of supposedly inexpugnable securities over which supervision is unnecessary, and a number of types of transactions which, it is felt, cannot result in fraud. At the same time, however, these exemptions may also occur in highly speculative securities, due to the desire of the state legislature to further the interests of some domestic industry. A number of acts,[8] in addition to containing a number of specific exemptions, are so worded as to apply only to "speculative" issues, hence impliedly exempting all "non-speculative" issues. These statutes are the so-called "speculative" blue sky laws.

Third, regulatory laws usually provide that dealers in securities must secure an annual license, obtainable upon the submission of satisfactory evidence of good character and financial responsibility, and the payment of a fee.[9] An issuer, selling its own issue only, does not obtain an annual license, but rather a specific permit to market the single issue.

The fourth characteristic of the typical regulatory blue sky law is the requirement that non-exempt issues must be individually accepted by the state before sales may take place.[10] To obtain

8. Kansas, New Mexico, Oklahoma, Virginia, Wyoming and others.

9. In a few states requiring licenses the provision does not apply to dealers handling exempt securities.

10. However, the rigors of this requirement are mitigated in the case of those regulatory statutes which provide for registration by notification or for temporary approval, as well as in the dealer-licensing states under whose acts only issuers obtain specific permits, professional dealers being allowed to sell freely during good behavior. A discussion of such statutory provisions follows.

such approval the person qualifying the security must furnish comprehensive information concerning the issuing company, its character, type of business, powers, properties, and financial structure, while additional information may be required at any time. Appraisals, investigations and audits may be made (at the expense of the applicant) if the commission so desires.

Finally, whether or not expressly granted by statute, the state commissions administering the provisions of regulatory securities legislation have power in practice to impose numerous additional conditions as prerequisites for sale of securities. The most common provisions are: First, that the issuing company shall escrow promoters' stock and stock exchanged for patents and services until other outstanding stock is on an earning basis, and secondly, that sales commissions shall be limited, usually to ten or fifteen per cent. of the face of the issue. When the securities commission is satisfied that the proposed offer will not "constitute a fraud upon the purchaser," it issues a permit (or registers the security in a book) allowing the sale of the issue within the state.

Sale of securities without approval of the state constitutes a violation of the blue sky laws, and the penalties are heavy, the North Carolina act, for example, providing that violators shall be punished by

> "a fine of not less than $200 nor more than $5000, or by imprisonment in jail or work on the roads for not exceeding two years, or by such fine and imprisonment."

A sale in violation of the law may be illegal, either because of an express provision of the act or through implication,[11] thus enabling a civil suit for recovery by a purchaser in case of loss.

Classes of Regulatory Blue Sky Laws

The foregoing discussion of the provisions usually found in a blue sky law of the regulatory type will make clear the general purpose, procedure and field of action of such statutes. This general survey of regulatory legislation completed, attention may now be directed to a consideration of several well-defined classes of securities laws which, although all falling within the regulatory type, deserve separate treatment because they emphasize various methods of regulating securities transactions. The several classes

11. Edward vs. Ioor, 205 Mich. 617.

of the regulatory type of the blue sky laws may be listed more fully as follows:

1. Laws regulating only "speculative" issues;
2. Laws providing specific permits in the case of issuers, but emphasizing the principle of allowing professional dealers to sell divers securities under a license continuing during good behavior;
3. Laws requiring specific permits for all issues and transactions not exempted in the statute;
4. Laws requiring specific permits generally, but allowing "temporary approval" in the case of better-class issues.
5. Laws requiring specific permits generally, but allowing "registration by notification" in the case of better-class issues.

"Speculative" Securities Acts.—Most of the early blue sky acts belonged to the first class listed above, and a number of states are yet operating under such statutes,[12] which endeavor to regulate only "speculative" securities, exempting all others either by express provision or by inference. Acts of this kind ordinarily provide that certain more or less definitely designated securities shall be considered "speculative."[13] Before such securities can be sold, they must be approved by the securities commission of the state. Issuers of and dealers in other classes of securities may sell without hindrance. The objection to "speculative" statutes, however, is that it is almost impossible as a practical matter to affirmatively

12. Kansas, New Mexico, Oklahoma, Virginia, Wyoming and others.

13. In New Mexico "speculative securities" include:

A. All securities to promote or induce the sale of which profit or advantage unusual in the ordinary course of legitimate business is in any way advertised or promised;
B. All securities for the sale of which a commission of more than five per cent. is promised or paid.
C. All securities into the specified par value of which, the element of chance or hazard, or speculative profit, or possible loss equals or predominates over the element of reasonable safety, certainty and investment;
D. All securities materially based upon patents, formulae, good will, promotion, or any intangible assets;
E. All securities based upon the sale of unimproved or undeveloped land on any deferred payment or installment plan, when such lands are not situated in the state of New Mexico;
F. All oil royalties or oil leases or interests therein, dependent for value upon future events.
G. And several other minor types of issues.

define all the securities to which the law is to apply, and this impossibility leads to two evils. In the first place, legitimate dealers and issuers cannot assume that their securities are outside the definition of speculative securities unless they are clearly so. While in the first instance a commission may consider a given securities issue non-speculative and hence unnecessary to qualify, the definition must finally be construed and applied after a loss by a jury either in a penal action by the state or in a civil suit for damages. In the second place, the vagueness of the definition of speculative issues in all these laws encourages swindlers to claim exemption for their fraudulent flotations on the ground that they are non-speculative and not covered by the statute.[14] The uncertainty of such legislation benefits only criminals, keeps reputable dealers in doubt as to their status, and throws the burden of proof upon the state to show that the securities sold come under the terms of "speculative securities."

Dealer-Licensing Acts.—Dealer-licensing statutes[15] are peculiar, for while other regulatory laws may provide for the licensing of dealers, this second class of regulatory acts depends for its effectiveness upon the restriction of the securities traffic primarily to carefully licensed dealers, who must be of good repute and have a fair, just and equitable plan of business, and secondarily to issuers who may sell their own securities only upon specific permits. Selling by an issuer cannot proceed until after final and definite approval of the offering by the commission, but a dealer (that is, a broker or underwriter), after obtaining his annual license, may sell divers securities without specific approval, being required merely to mail to the state officials copies of advertising literature or securities offers.[16] The commission may investigate the sales

14. See Watters and Martin vs. Homes Corp, 116 S. E. 336, where, the law providing that speculative securities included those issued in "material" part for services, the defendant promoters pleaded that receipt of 33 per cent. of the stock of their corporation for promotional services did not bring the issue within the act. This case illustrates the lengths to which it is possible for quibbling swindlers to proceed in an effort to legitimatize their transactions under a "speculative" blue sky act.

15. Dealer-licensing acts, so-called, are found in Kentucky, Maine, Montana, Massachusetts, New Hampshire, Pennsylvania, Rhode Island, Vermond, and (as enforced) in Washington. In California, domestic issues are sold under specific permits, and foreign issues are marketed by vendors operating under annual licenses.

16. In New Hampshire this is not required, the act providing merely that the commission may require information in case fraud is suspected.

of a dealer, and if it finds a security to be objectionable it may suspend the sale of the issue and perhaps revoke the dealer's license. The theory is that most securities are marketed through professional dealers, and that if these dealers are carefully recruited from the ranks of honest men, the securities which they sell will probably be *bona fide* and dependable.

Specific-Approval Acts.—The peculiar characteristic of specific-approval securities statutes, which comprise the third class of regulatory blue sky statutes, is that although dealers may be licensed,[17] and although fraud-act clauses may be inserted in the acts,[18] these statutes provide that the state shall supervise securities transactions through its control of individual securities by specific approval in each instance.[19] The commission is required to investigate and approve (by a permit, registry, filing or some other similar device) all issues other than a certain group which is explicitly exempted from the jurisdiction of the act. These laws have met with appreciable success in checking fraud, but they impose so many duties upon all issuers of and dealers in securities that their administration seriously obstructs the marketing or reputable (although non-exempt) securities;[20] and to these reputable securities, *ex concesso,* numerous states formerly operating under strictly specific-approval statutes have now come to accord additional freedom through the insertion in their blue sky legislation of provisions either for the temporary approval of certain classes of securities or for their registration by notification.

Acts Providing for Temporary Approval.—Illinois took the lead in the above-mentioned remedial movement to lessen the burden of regulation upon the legitimate securities business by providing, in its elaborate classification act of 1919, that the previously (1) exempt and (2) non-exempt securities should be re-grouped into four classes, as follows:

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17. In Illinois, which has taken a leading part in the regulating of the securities field, no annual licenses for dealers were required, however, until 1925.

18. As in the Virginia act.

19. The acts of Alabama, Arkansas, Florida, Idaho, Iowa, Mississippi, Missouri, Ohio, Oregon, North Carolina, South Carolina, South Dakota, Tennessee, Texas and Wisconsin, are illustrations.

20. The manner in which specific-approval blue sky laws obstruct the marketing of legitimate securities is discussed in chapter four of this study.

A. Securities safe because of inherent qualities;
B. Securities safe because of the nature of the parties connected with their sale;
C. Securities based upon established income;
D. Securities based upon prospective income.

Classes A and B are exempted from regulation, and Class D remains under strict control through specific permits, while for Class C securities, which are presumably legitimate issues but which fail to attain the status of exempt obligations, the device of temporary approval was contrived, under which the commission, when apprised by a dealer or issuer of his intention to offer such securities, grants within a few hours permission to proceed with their sale. The required notice of intention, however, contains a certain amount of proof of the meritorious nature of the securities. The statement must include a "detailed statement of the assets and liabilities of the issuer and an income or a profit and loss statement, and give an analysis of the surplus account," as well as facts establishing that the securities are in Class C.

The 1920 Georgia law follows the classification scheme of the Illinois act, and other states provide for the temporary approval of reputable securities as determined by the state commission, these provisions being administered usually for the benefit of the professional broker, or dealer, as distinguished from an issuer.[21]

On the other hand, the Wisconsin classification of non-exempt securities into A (investment) and B (speculative) grades differs from the above-mentioned classifications in Illinois and Georgia in that, although Wisconsin dealers and issuers may market Class A securities immediately upon application for a permit (that is, without awaiting final approval), no temporary approval is granted, and the vendors must offer to repurchase all securities which have been sold in case approval is finally refused. Missouri follows Wisconsin by providing "temporary registration of non-exempt legitimate securities, by reliable licensed dealers, by giving bond, pending investigation."

Acts Providing Registration by Notification.—The most recent forward step which has been taken in reducing the burden which

21. California, Michigan and Washington, while certain commissions forego the qualification of reputable non-exempt securities, even though required by statute.

regulation imposes upon reliable issues is the plan of registration by notification, whereby certain of the better types of investment securities are admitted to sale simply on notification to the commissions of such tender being made,[22] the commission being authorized, on their belief that such offerings might work a fraud, to suspend the issues from sale during investigation. Acts embodying this provision were passed in Indiana, Minnesota, Utah and West Virginia in 1925. The principle back of registration by notification is to license the dealer with great care, thereafter allowing him considerable freedom. The commissions, however, are empowered to require additional information, and it is possible that these provisions for registration by notification might have a hampering effect upon the marketing of securities if cautious officials should consistently suspend sales while awaiting further assurance of merit. On the other hand, the securities commissioner of Indiana states that although the great bulk of the securities sold in that state since the passage of the 1925 act have been registered by notification, his office has suspended the sale of only a half-dozen issues.

Special Provisions of Blue Sky Laws

A perusal of the following special provisions occurring in the blue sky laws will throw additional light upon the scope and purpose of the various securities acts.

Swindling in stocks and bonds may be accomplished either by selling the victim a worthless security or by cheating him in connection with one having some value. The first method of financial plundering is usually promotional, while success in the second field of fraud is dependent upon bucketing, high-powered salesmanship,

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22. Notification consists in filing brief statements, including the name of the issuer, a description of the securities intended to be offered, the amount of the offer, a summary of the facts which establish it to be within one of the classes entitling it to such registration, the offering price, and a circular or advertising prospectus. The classes entitled to registration in Indiana are:

1. Established companies earning on the average one and one-half times total interest charges, or six per cent. on total common stock;
2. Rental bonds on real estate leased to exempt companies;
3. Realty bonds covering not over 70 per cent. of the fair market value of the mortgaged property;
4. Preferred stock of real estate companies, if said stock aggregates less than 70 per cent. of the equities at fair value, or if earnings aggregate dividend requirements plus three per cent. on said preferred stock.

misleading information and other similar wiles and artifices. Inasmuch as the same class of monetary pirate functions in both types of activity, it is natural that the blue sky laws of many states, in addition to controlling the flotation of new issues, should regulate dealers in securities through licenses, and occasionally include specific provisions against bucketing, although for the most part special laws have been enacted against bucketshops and fraudulent brokerage offices, which acts may or may not be administered by the securities commissions of the states.

Further, blue sky commissions frequently supervise foreign, and even domestic, real estate promotions. The Ohio securities act provides for the certification of real estate issues if the involved realty is not located within the state and "many applications are rejected and only a few allowed. The investing public in Ohio cannot be too well safeguarded in the sale of foreign real estate." [23] Similar control over foreign real estate is exercised by the commissions of Wisconsin, Iowa (in part), Mississippi, New Mexico and other states, while the Michigan commission, functioning under a separate law, controls methods of selling real estate, whether it is located within the state or abroad.

In carrying out their duties under blue sky laws, securities commissions compel the escrow of promoters' stock until the corporations are firmly established, limit distributors' commissions, require the bonding of licensees and permittees in many cases, and provide for the valuation of patents and property exchanged for corporate stock. The licensing of agents or salesmen is also a modern tendency, as are provisions placing the burden of proof upon persons claiming the benefit of exempting clauses or accused of violating the acts. Illinois, Wisconsin and Michigan carry their supervision of new companies far past the period of promotion, not primarily to prevent fraud, but to compel the observance of conservative business principles by inexperienced enterprisers. New companies are inspected, systematic accounting methods and financial and operating statements are required, and in Michigan inventors' companies are often compelled to allow the commission for a year or more to countersign their checks, in order to prevent dissipation of the companies' money in unbusinesslike projects.

23. Mr. N. E. Beck, chief of the Ohio division of securities.

A Summary of the Different Types and Classes of Blue Sky Laws

In summarizing the foregoing description of the various types and classes of blue sky laws, it may be said, briefly, that blue sky laws are divided into two main types, fraud acts and regulatory acts. Fraud acts seek to prevent fraud by punishing swindlers and thus frightening away other potential criminals. Regulatory acts, on the other hand, seek to prevent fraud before its commission by supervising either sellers of securities or the securities themselves. Regulatory acts primarily controlling vendors are called "dealer-licensing" laws, under which professional dealers are granted annual licenses and afterwards sell freely during good behavior. So far as individual issuers of securities are concerned, dealer-licensing acts require them to obtain specific permits to sell their single issues. As contrasted with dealer-licensing acts, other regulatory acts seek to control the securities traffic by supervising each specific issue. These latter acts are the "specific-approval" statutes. The burden which they have imposed upon legitimate securities houses has resulted in the invention of temporary approval and registration by notification, whereby, although the principle of specific approval is maintained, yet the burden upon reputable dealers is decreased by making it easier for them to qualify better-grade securities and consequently to proceed more quickly with their sale.

III

THE ECONOMIC EFFECT OF BLUE SKY LAWS UPON HIGH-GRADE SECURITIES

High-grade securities have been described as consisting of stocks and bonds of relatively low income yields, possessing adequate margins of safety and comprising in most cases the issues of established enterprises with a satisfactory earning record.[1] The economic effect of blue sky laws upon these securities consists chiefly in the obstructive influence exercised over their distribution after issue.

A consideration of the first type of blue sky laws, namely, the fraud acts of New York and other states, leads to the conclusion that these statutes do not in any way obstruct the marketing of legitimate stocks and bonds, since virtually all action under fraud legislation is undertaken by the state after the inauguration of securities sales, and consequently it is only under the most unreasonable attorney generals and courts that such acts can hamper the marketing of investment obligations. Equally inoffensive is the first class of regulatory blue sky laws, that is, dealer-licensing acts, so far as the sale of securities by professional dealers is concerned. It is true that in case an issuer desires to market its own securities, necessitating approval of the issuer's plan of business by the commission, the issue may occasionally be delayed pending investigation, but subject to this qualification dealer-licensing blue sky laws do not hamper the marketing of legitimate securities. The accusation of obstructing the marketing process rests for the most part against the second class of regulatory blue sky laws, that is, those acts regulating individual issues of non-exempt stocks and bonds by requiring for them specific permits or registry. It is these laws which by their requirements of comprehensive statements and information have fastened so many restrictions upon the legitimate securities traffic that investment bankers have seen in such acts a serious threat to their business and hence opposed them.

An explanation of the syndicating process by which national securities issues are floated will make clearer the hampering effect of specific-approval blue sky laws upon legtimate dealers whose

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1. Sometimes, of course, the attractiveness of the investment arises from other causes, as in the case of equipment trust bonds, good real estate mortgages or receivers' obligations.

business is national in scope. An investment banker buys securities and sells them. When he commits himself to the purchase of a large issue of stocks or bonds, he proceeds to shift a large part of his risk as rapidly as possible by forming an underwriting syndicate of investment bankers whose clientele of correspondent dealers and customers may be scattered throughout many states. This plan shortens the selling process and lessens the danger of fluctuations in the money market while the securities are on hand. The participants in the syndicate distribute the securities through correspondent dealers who reach their clientele by means of personal solicitation, telephone messages and use of the mails. Speed is the essence of the syndicating function, and the entire marketing may consume but a day, the syndicate being formed, dealers interested and sales effected by telegraph or telephone, actual transfer of the securities awaiting issuance and delivery.

Despite the exemption from regulation of certain securities and transactions which is provided for by all regulatory securities legislation, it is nevertheless a fact that specific-approval acts may easily do injury to the commerce and industry of the nation, especially when such statutes attempt to control companies doing business on a national scale and possessing a nation-wide market for their securities. Issues of many millions of par value cannot be distributed locally, but must be sold for the most part over the entire United States. Such a flotation is underwritten in one of the great financial centers by a group of bankers, and that group, in turn, distributes the issue throughout the country by means of its sub-underwriters and correspondent dealers. The operation must be carried on speedily, and completed while the market is ready to receive the securities. But if the issue must be qualified before numerous commissions, each enforcing slightly different specific-approval laws, a permit may be obtained in a few days in one state and yet in another state it may require many months to qualify securities, often not because of any fault in the securities themselves, but merely because of the physical impossibility of assembling the required data more quickly.[2] As the case was put at the investment bankers' convention of 1919,

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2. Perusal of the following tedius list of required information will make clearer the comprehensive nature of a blue sky inquisition when carried to its full extent. Prospective sellers of securities in specific-approval states may be required to furnish:

1. Intelligence exacted through application blanks;

"The different sets of papers which must be prepared to fulfill the different qualifications place investment bankers and dealers in a difficult situation. Instances occur whereby very serious loss is suffered by dealers in securities because they are unable to qualify their securities in certain states, causing them to lose their market. One dealer, through failure to qualify a security in a large investment state, was caught recently at the end of an active investment month with a half million dollars in bonds which that state could have absorbed easily had he had an opportunity to offer them promptly and readily." [3]

It often requires a great expenditure of time in order to obtain permits in a number of states operating under diverse laws and requiring different kinds of information, and meanwhile the current rate of interest may rise, to the detriment of the dealer holding unsold securities. Many states, however, require the underwriter

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2. Certified copies of the articles of incorporation of the applicant company; its by-laws; the minutes of the first meeting of stockholders and directors; the minutes of the stockholders' and directors' meeting relative to the issue in question;
3. Statements describing fully the real estate, plant, equipment, patents, promotion, organization, or other consideration, and the amount and kind of stock issued therefor;
4. Appraisals, made by competent and disinterested persons and duly verified, covering all properties securing the issues for whose certification application is made;
5. Opinions of attorneys who have examined abstracts of title to real estate;
6. Original written opinions, or certified copies thereof, of attorneys who have examined and passed upon the record of title to properties leased;
7. Copies of all contracts, stocks and bonds or other securities which it is proposed to make, sell or negotiate to sell;
8. Sample copies of all literature or advertising matter used or to be used by the applicant or dealer in the sale of the securities in question;
9. Copies of any mortgage deeds of trust;
10. Statements of amounts of all insurance policies upon the physical property of the applicant, with names of companies issuing said policies;
11. Copies of contracts between the applicant and the investment banker for the sale of the securities;
12. Copies of certificates, executed by the proper officer of its parent state, showing that the applicant company is authorized to transact business in such state;
13. Copies of the opinions of attorneys, certifying that the company has satisfied all legal and statutory requirements of its parent state;
14. Opinions of attorneys concerning the validity of the issue in question;
15. Consent to be sued by service upon a designated officer of the state;
16. Affidavits to prove the business experience of the corporate directors;
17. Statements of securities, other than those designated on application blank, which have been awarded for considerations other than actual cash;
18. Statements of notes given applicant for securities, with details as to the drawers, dates and maturities.

3. Mr. Barrett Wendell, Jr., Proceedings of the Convention of the Investment Bankers Association of America, 1919, page 133.

to state the buying price and his margin of profit, which means that the underwriting dealer and the issuing corporation must take the risk of market fluctuations in the interest rate between the time they begin to prepare the required information and the time of sal. The marketing of securities cannot be undertaken by dealers until after the underwriters have come to a definite agreement with the issuer of the obligations, and any law necessitating a long interval of time between the time of decision of the terms and the time of actual offering to the public is an almost insuperable handicap to the securities underwriter or dealer. Further, in case of a small allotment of stocks or bonds, it is hardly worth while to qualify it widely when authorization involves the expensive preparation of detailed information for several states each enforcing slightly different laws.

The truth of the above reasoning has gradually been made evident, but believers in specific-approval legislation nevertheless defend it on the grounds that either:

1. The act of the advocate's own state is inoffensive because provision is made for registration by notification, temporary approval, sales under bond, or exemption of "non-speculative" issues;
2. National issues, to which the above reasoning most cogently applies, have not been sold in the apologist's state in the past, and would probably not be marketed therein under any circumstances;
3. No foreign issues of any kind should be sold to local investors; or that
4. The obstructive effect of the acts is a lesser evil incident to a greater good; that is, the elimination of securities fraud.

The first defense of specific-approval blue sky laws noted above is in some cases partial vindication, in other cases merely palliation. In the case of statutes making provision for registration by notification of certain types of corporate obligations, provided that the list of securities entitled to such treatment is sufficiently comprehensive, the partisan may claim with some show of reason that the resultant burden upon legitimate dealers, under a competent commission, is not insuperable. Provisions for temporary approval usually (although not always) eliminate most of the delay con-

nected with the qualifying of high-grade securities, but may not apply to a sufficiently wide range of securities. Despite the application of provisions for temporary approval and registration by notification, some burden remains upon the seller of legitimate securities, and to reduce it by broadening the class of stocks and bonds entitled to such treatment opens breaches in the law of which financial swindlers may take advantage. The practice of "issuing 'licenses' (permits) where all blank spaces in the application blanks are not filled out, if it apparent that the applicant is in good repute" is merely an official evasion of the law, and equally precarious was the determination of the authorities of two western states (later partially reversed in one case) not to interfere, under ambiguous laws, with reputable dealers. The defense that dealers may sell under bond without awaiting final approval of their application is unsound, as this would render them temporary guarantors against loss in cases where final approval is refused and they must offer to repurchase the securities; the defense that the "speculative" acts place no hindrance in the way of the movement of legitimate securities, since they regulate only "speculative" issues, is objectionable, since such acts place dealers and issuers under a continuing civil liability and render them uncertain of their status; and still more improper is the statement of an eastern commission which operates under a specific-approval act that "our act does not hamper legitimate business, as applications go through usually *in a week or so,*" since this statement indicates the failure of the commission to realize that speed is the desideratum of the securities marketing process as applied to national issues.

Secondly, specific-approval securities acts are sometimes defended against the accusation of hampering the marketing of legitimate issues by pleading that experience has shown that the state concerned is not a market for national issues. The second defense may be answered by the statement that the existing law, by practically barring most foreign issues, constricts the investment channels open to the local investor, and that under a more lenient statute national issues might enter the state in quantity.

It is hardly necessary to refute at length the statements of those restrictive protectionists who defend rigid specific-approval laws upon the third ground that, for the most part, such acts burden only national issues floated in other states, and that the prohibition of the sale of these foreign securities is a positive benefit to the local investor. One proponent of this point of view states that:

> "I am of the opinion that the sale of securities by solicitors should really be entirely prevented. Hardly any sales that have ever been made in this state have turned out profitable to the investor. There are always safe investments at home which ordinary people would do better to put their money in,"

but the above quotation savors more of the medieval ages than of the modern economic era, and the fact is that the welfare of all classes of society demands complete mobility of capital.

Finally, specific-approval blue sky laws may be defended as regulators of the securities field upon the fourth groud, to the effect that their hampering effect upon the legitimate securities traffic is incidental to the supervision necessary for the prevention of fraud. This defense can be logically continued unless and until the advocate of such acts is convinced that some other type of legislation, such as legislation providing for the licensing of dealers and the granting of specific permits only to individual issuers marketing their own flotations, would assure greater freedom to the legitimate securities traffic and yet function with equal or greater efficiency against the fraudulent exploitation of corporate obligations.

Summarizing the economic effect of blue sky laws upon high-grade securities, then, it may be said that on the whole securities legislation has affected the issue of such obligations unfavorably, due to the impediments which the laws place in the way of their distribution, thus hampering the movement of capital along its normal economic channels. On the other hand, the economic influence of blue sky laws upon speculative and fraudulent securities, as described in the following chapters, is such that a certain amount of additional capital is released from investment or waste in these latter classes of obligations and made available for potential placement in more conservative stocks and bonds, and to this extent the economic influence of the statutes upon high-grade securities is ameliorated. This indirect benefit, however, by no means counteracts the major unfavorable effect.

IV

THE ECONOMIC EFFECT OF BLUE SKY LAWS UPON LOW-GRADE OR SPECULATIVE SECURITIES

Speculative securities, as the phrase is here used, are those corporate issues based upon future probabilities. These securities are not necessarily tainted by fraud, but they are the stocks and (sometimes) bonds of corporations engaged in new and hence untested lines of industry; of new and hence untried companies in staple lines of industry; and of businesses engaged in lines which are essentially speculative in their nature—that normally involve a high degree of risk. In this class of securities is most frequently found the fraudulent element and the attempts to perpetrate fraud by those so inclined. The economic effects of blue sky laws upon speculative issues may be analyzed under four heads: First, the tendency of the securities statutes to hamper the marketing of such issues, even when their distribution is allowed; second, the influence of blue sky laws in raising the standards of corporate financing and corporate administration, and thus eliminating a part of the speculative risk involved; third, the implication of state endorsement through its authorization to sell; and fourth, the influence of blue sky laws in prohibiting speculative corporate ventures and thus impeding the flow of capital into new or untried economic fields.

Hindrances to Marketing

Upon the first head, it may be said that just as blue sky laws hamper the distribution of high-grade securities, so do they hamper the marketing of speculative securities, but in greater degree. This is, of course, a matter apart from the attribute of mere acceptability to the supervising commissions. The additional delays arise from the fact that applications for permission to sell speculative issues are subjected to a closer and more prolonged scrutiny.

The procedure through which these applications pass may vary, according to the size of the staff of the securities commission concerned, and the thoroughness with which the applications are investigated. In Wisconsin, after an application is received and has been given the usual formal docketing by the filing department, it is assigned to one of the staff examiners. It is the duty of the examiner to make a thorough investigation of the plan of financing, examine the financial data, trust indentures, opinions on title, opin-

ions on legality, leases and other documents. In short, it is his job to ascertain whether the application conforms to statutory requirements and to make recommendations as to the disposition of any application. There are special fields in which the regular staff examiners are not qualified, and in such cases assisting consultants are employed. If it is a problem of building costs, a consulting engineer must go over the application and not infrequently examine the property itself. If the application covers an oil or gas enterprise, particularly a new enterprise which has had no production and can show no earnings, a consulting geologist examines the data submitted and before action is taken a report must be submitted either by him or by some reputable geologist acceptable to hmi. In the case of a mining company, consulting mining engineers follow the same procedure.[1] When the special report has been made, the application is again referred to the staff examiner, who, in turn, must examine all factors other than the special phase which the consultant's report covers. The staff examiner then makes his recommendations to the director of the securities division, and if the director agrees with these recommendations, action is taken accordingly. Occasionally it is necessary to hold hearings and special conferences for the purpose of obtaining additional evidence. Usually the question of a denial is laid before the three commissioners themselves because of the possibility of an appeal from the commission's order. In the entire history of the commission, however, since 1919, there has been only one appeal from any decision of the commission.

In Oregon, the applications when filed are received by the chief clerk of the securities department and recorded and checked to see if tha pplicant has submitted the documents as required and also if sufficient fee has been submitted. The applications are then referred to the examiner-auditor for full examination and investigation. Such examination sometimes requires personal inquiry concerning the company's property. This, of course, depends upon the showing made by the company on their application, the character of the securities for which application has been made for permit, and the business in which the company is engaged. Where the economic character of the enterprise is in question the investi-

1. Some years ago a cemetery promotion scheme was presented to the Wisconsin securities commission for approval, and it was necessary to employ as consultant a landscape architect, who, incidentally, discovered that the plans submitted by the promoters would have created a veritable forest on the land which was to be used for a cemetery.

gation is often prolonged, sometimes over a period of months. After such examination, a report is rendered the corporation commission recommending that the permit be granted as applied for or that the application be denied. The application is again reviewed and final action taken by the commissioner.

In California, upon the filing of an application to sell a security and the payment of the filing fee, a deputy receives the indexed application and makes an examination of it to make sure that the usual necessary exhibits are attached, making a note of any missing and communicating with the attorney or person filing the application to that effect. The application is then passed on to a deputy who assigns it to the deputy or engineer who will write the permit or recommend a denial. Mining and oil applications are assigned to engineers, while industrial applications are handled by deputies who have been admitted to practice at the California bar. The application is further examined by the deputy after its return from the auditing department, and if the plan is deemed to be fair, just and equitable he will dictate a permit.

In the above-mentioned states, as in most others, the closeness with which applications to sell securities are investigated depends to a large extent upon the judgment of the commission as to the nature of the issue. In many cases high-grade issues are approved without requiring full proof of their merit, although this proof is necessary, according to a strict interpretation of the statutes. In the case of securities which the commissions believe to be of a speculative nature, however, the investigation is detailed and comprehensive, which entails a longer delay in the granting of permits.

The Influence of Blue Sky Enforcement upon Standards of Corporate Financing and Administration

Under this second head, it may be said that the operation and enforcement of blue sky laws affects speculative securities by raising standards of corporate financing and corporate administration in numerous ways and thus eliminating a portion of the risk involved. For instance, limitations and restrictions placed upon "water" in corporate financing tend to raise the standard. The same end is forwarded by the limitation of organization and promotion expenses, and the careful consideration of the adequacy of the proposed capital. Again, it may be important to prevent the dissipation of capital by requiring all funds to be impounded until

a sufficient amount has been accumulated to carry out the program of the corporation. As to the actual effect upon standards of corporation financing of the enforcement of blue sky laws, some conclusions may be arrived at by considering the practical requirements of the securities commissions along this line.

Escrow of Stock Issued for Intangibles.—When stock is issued for some intangible asset such as patents, formulae or services, most commissions require that such stock be placed in escrow under conditions prohibiting its sale until the company shall have earned certain profits. The amount varies with the type of the enterprise. The escrow agreement often provides further that if the amount stipulated shall not be earned within a certain number of years from the date thereof, the stock shall be returned to the company for cancellation; usually this period is five years. The agreement also provides that in case of dissolution or liquidation during the period in which the stock is in escrow, the escrowed stock shall not participate in the distribution of assets until all other shareholders shall have been paid par for their shares in the case of par value stock. This sort of escrow agreement is designed, of course, to prevent promoters from making a profit out of a worthless patent, formula or some other intangible asset. If, within five years, the device can be shown to be practicable, the promoters may be entitled to the stock issued for such asset. It is significant that in very few cases have the terms of the escrow agreement been fulfilled and the stock thereunder released.

Adequacy of Capital.—There is quite as much danger in the under-capitalization of a new corporation as in its over-capitalization, and some securities commissions frequently have occasion to direct the attention of promoters to the fact that they are not providing sufficient capital to enable them to carry out the program which they have outlined. The standards of corporate financing should be benefited by the avoidance of both over- and under-capitalization.

Limitation of Organization Expenses and Sales Commissions.—Virtually all securities authorities now restrict organization expenses of new corporations and the commissions connected with the sale of their securities within some certain percentage of the par value of the stocks and bonds. This limit is usually 15 per cent.,

which would assure the receipt by the treasury of the corporation of 85 per cent. of the face of the outstanding obligations. Obviously the limitations thus placed upon these promotion and organization expenses and commissions are a conservation of capital.

Impounding of Funds Until Sale of Issue Is Completed.—In some states use is made of another provision to which the dissipation of capital has conduced, that is, the impounding of all funds received from the sale of securities until the distribution of the issue is completed. This temporary impounding of funds is the result of experience with many new corporations whose capital was largely dissipated even before operations were begun upon any substantial scale. It may be helpful to stock salesmen to show pictures of beautiful factories, and to the inexperienced investor a handsome factory site and substantially built factory buildings give the appearance of permanency and stability. But it is bad financing to sink all one's capital into fixed assets; and especially is this true when an enterprise has neither demonstrated that it has a marketable commodity or that it has the ability to secure a market for its product. It is no burden to require the funds to be impounded until sufficient capital is obtained to assure an operating existence to the company. In fact, there have been frequent cases where it has been impossible to obtain sufficient capital and the funds on deposit with the trustee have been redistributed among the subscribers *pro rata.*

Non-Par Common Stock Exercising Corporate Control.—No uniform attitude has been taken by securities commissions toward the issue and sale of non-par common stock exercising corporate control. The South Dakota securities commission takes a radical position in this matter and refuses to authorize the sale of any non-par stock. Kansas and Illinois refuse to allow the sale of common stock under any circumstances unless it possesses voting power, while Pennsylvania has refused to approve the issuance, *without consideration,* of non-par common stock exercising exclusive voting power. On the other hand, Ohio, Wisconsin and most other leading states have taken no definite stand against the issue of common stock which carries no voting power. In general it may be said that while there is some tendency toward restricting the issue of "management" shares, this tendency has not as yet developed much strength.

Attitude Toward Preferred Stock.—The tendency of securities commissions to protect the interests of preferred stockholders is indicated by a variety of practices. For instance, the Pennsylvania commission has insisted that all preferred stock issues must be preferred issues not merely by description, but must be preferred issues in fact, in that there must be a prior junior investment before a senior preference lien can be created. In most states, preferred stockholders must possess deferred voting power, to be exercised in case dividends on the preferred are unpaid for a certain number of years, or, occasionally, in case the company fails to maintain at all times net tangible assets equal to twice the outstanding preferred. In some states, the issue of non-cumulative-dividend preferred stock is not approved under any circumstances.

In Ohio, the commission will not grant a certificate to sell preferred stock unless the applicant agrees to pay an amount for the common stock at least equal to the expense of floating the preferred. For example, assume a company with 10,000 shares of preferred (par $100) and 10,000 shares of non-par common, to be sold to the public in units of two shares of preferred and one share of common at a sales expense of ten per cent., and the promoters to receive the remaining 5000 shares of common. In this case, the promoters would be compelled to raise $100,000 on the 5000 shares of common that they were to receive, in this way maintaining the preferred at par throughout the operation.

Again, the Wisconsin commission will not permit a new company or a company which has not been in successful operation to issue a straight preferred stock. In other words, in a business enterprise which has not established its ability to earn the preferred dividends, the commission requires either the participation in earnings for the preferred stock over and above its stipulated dividend, or the distribution of the common stock with the preferred stock so as to assure the preferred stockholders an equitable proportion of the profits.

Deferred voting power is given by the Indiana securities commission to realty preferred stock. This is the preferred stock of an Indiana corporation organized purely to hold real estate. This form of organization issues preferred stock which takes the place of real estate mortgage bonds, the purpose being to avoid taxation. In this type of financing, the commission has insisted that in the event of default in the obligations for one year, the preferred stock-

holders have equal rights with the common stockholders to vote in the election of directors and officers.

Comparing the present situation with that of the period prior to the enactment of effective blue sky laws, it appears to be the case that standards of corporate financing in most states have been materially improved. Generally speaking, persons participating at present in the organization of corporations are more particular in the arrangement of their articles of incorporation and are exercising greater care in the fundamentals of financing the proposed enterprises. Further, closer attention is being accorded, by the promoter, the public and the state commission alike, to all the different rights, privileges and obligations inherent in securities issues.

Another result of blue sky laws and their enforcement is a lessened mortality of new corporations in some states because the companies are introduced at birth to proper bookkeeping proctices and realization of the necessity of sound financial procedure in their business affairs. Officers of certain corporations, now well-established, have confessed that their companies would have failed in their first year of existence had the officials not had constantly before them the necessity of rendering semi-annual statements to the securities commissions detailing the activities of their concerns.

Blue Sky Enforcement as an Implied Endorsement of Authorized Securities

Under this head, it may be said that, according to the consensus of opinion, one important economic result of te enforcement of securities legislation is the implication of a state endorsement of all securities authorized to be sold. If a state in any manner authorizes the sale of securities, the public is prone to believe the statements of ignorant or dishonest salesmen of stocks and bonds that the state would not have authorized unfit securities for sale, and consequently the offered issue is a desirable investment; and many buyers purchase on the strength of the fact that the state commission has approved the security.[2] The imposition of supervisory duties upon state officials (even though they may be impossible of complete fulfilment[3]) has produced a false sense of safety

2. Mr. W. R. Shands, in Proc. N. A. S. C., page 68.

3. "The Michigan commission is often unable to perform the detailed duties allotted it, but the public takes it for granted that they are accomplished and hence implies a guarantee that the issues and underlying businesses have been investigated and found to be sound."—Mr. H. B. Thompson, secretary-treasurer, Better Business Bureau, Detroit, Michigan.

among securities purchasers, a large proportion of whom look upon any state approval for sale as an official endorsement of the offered security. Further, this unsound idea has been strengthened by positive statements of certain commissioners that it is their intention to consider the merits of individual issues.

Prohibitions of Speculative Corporate Ventures Are Hindrances to Economic Progress

Blue sky laws may affect speculative issues by diminishing their volume, where administrators refuse registration upon the theory that certain of the flotations are not safe investments for investors residing in the states concerned. The attitude of state blue sky commissioners toward the intrinsic merits of corporate issues is a matter of considerable dispute. According to one:[1]

> "the commissions claim the right to prohibit the financing of foredoomed promotions even by investors who 'have their eyes open,' just as, for instance, the states compelled life insurance companies (after the Armstrong insurance investigation in New York) to establish cash-surrender values in policies, even though policyholders had knowingly entered into contracts otherwise providing, or, as another illustration, just as dangerous scenic railways are prohibited."

On the other hand, most commissioners state that such prohibitions of securities issues are applied only to the most obvious follies of over-eager promoters, claiming that in general they seek to eliminate not risk, but merely fraud, and that if the plan of business is reasonably fair and the promoters of good repute, the sale of the securities will be commonly approved. The Michigan commission

> "cannot refuse to list or approve an issue because the security is highly speculative, or unsuited to the average buyer. Rejection must be on the ground that the sale is obviously a fraud upon the buyer, or made on unfair terms."

In Wisconsin, while

> "a few businesses with obviously 'no business chance' are refused a permit, most of them are approved and allowed to sell their obligations in the state."[5]

4. Mr. Walter J. Fallows, deputy secretary of banking in the state of Pennsylvania.

5. Miss O. M. Steig, of the Wisconsin Securities Commission. There have been, for instance, applications for oil ventures where the Wisconsin

Nor does the Washington law attempt to guarantee the success of any business venture.

> "The state cannot assume the risk inherent in such undertakings, nor can it underwrite the ordinary hazards involved in profit-making. Neither can it legislate prudence into investors." [6]

In other states, however, the officials definitely express their intention to evaluate the intrinsic merits of speculative securities,[7] and long experience in the securities field leads certain investment bankers and representatives of Better Business Bureaus to conclud that state commissioners of securities,

> "regardless of the wording of the laws, believe that the state should assume the responsibility of evaluating securities issues, and more and more are coming to think it their duty to judge promotions as to hazard." [8]

On the whole, although most securities commissioners may disclaim jurisdiction over the chances for profit possessed by new corporate flotations, and although some commissioners may strive

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commission has been satisfied from geological reports that oil cannot be found in commercial quantities, but the persons promoting the enterprises have acted in entire good faith and have been willing to sell stock purely as a gamble—nothing more. If under such circumstances investors wish to take a chance, realizing the very risk that they are taking, the commission has not felt that it should interfere to the extent of refusing a permit. In such cases, however, the commission has taken the precaution of insisting that the subscription contract used in the sale of the stock recite all of the material facts with reference to reports prepared by reputable geologists and their conclusions as to the possibility of striking oil.

6. Mr. H. L. Gregory, securities commissioner of Washington.

7. "Proper officials of the Ohio securities department pass not only upon the legality of the proposed issue but also upon the merits of the proposition, thus insuring to the investor more and better protection."—Mr. N. E. Beck, Chief, Ohio Securities Department, writing in *Finance and Industry,* February 28, 1925.

The attitude of the Kentucky commission upon this point is revealed by the questions which the department carefully considers in approving issues:

"1. Will the management be capable and efficient?
"2. Is there a demand for the commodity to be produced?
"3. Can it be produced in sufficient quantities to supply the demand and take care of the probable increase in business?
"4. Is the raw material close at hand and can it be handled economically in order to compete with other concerns in the same line of business?
"5. Are the shipping facilities adequate to handle the business and is there sufficient labor in the vicinity to work the plant?
"6. Will there be sufficient capital to maintain and operate the enterprise?"

8. Mr. H. L. Baldensperger, of the Associated Advertising Clubs of the World.

more or less successfully to avoid the question, it may be concluded that blue sky laws, as a class, subject speculative stocks and bonds to a state inspection which to some extent attempts to determine their future value. In this way the state interferes with a natural movement of capital into new fields of industrial and commercial experimentation, and the social desirability of this economic effect is discussed in the final chapter of this study.

Summarizing the economic effects of blue sky laws upon speculative securities, then, it may be said that these statutes hamper the distribution of speculative securities through delay; do something to raise standards of corporate financing and administration; imply a state endorsement of securities authorized to be sold; and finally impede the flow of capital into new or untried fields of exploitation.

V

THE ECONOMIC EFFECT OF BLUE SKY LAWS UPON FRAUDULENT SECURITIES

Fraudulent corporate securities are those stocks and bonds issued by promoters who realize the worthlessness of their flotations and marketed by vendors who mislead the purchasers with promises of fabulous returns, well knowing in most cases that the securities are based upon nothing more substantial than some schemer's castles in the air. Further, in the issue and sale of fraudulent securities, both promoter and vendor commonly expect to gain a profit from the flotation at the expense of the purchaser of the securities.

The effects of the enforcement of blue sky laws upon these fraudulent issues may be discussed as to (1) the tendency of securities legislation to eliminate these flotations; (2) the effect of official laxness and political corruption upon the operation of the laws; (3) the effect of the administration of the laws by inexperienced officials; (4) the effect of statutory loopholes; (5) the effect of "compounding" practices; (6) the effect of lack of regulation of partial payment houses; (7) the effect of interstate mail swindling, and (8) the difficulty of punishing financial criminals.

Reduction of Fraud

Despite the paucity of statistical information concerning the operation of blue sky laws, it is nevertheless possible to present some comparisons which are based upon a certain amount of compiled data which are indicative of the effectiveness of securities acts in reducing the fraud connected with the issue and sale of corporate obligations by financial swindlers. The first of these tests consists in comparing the ratio of applications to licenses or permits granted for the year of establishment of each commission with like ratios for succeeding years. This test is based upon the fact that fraudulent schemers who may be operating in a state at the time a blue sky law is passed will readily apply for authorization to continue their activities, in view of the fact that they have little to lose by such applications and on the other hand if their applications are granted will gain. The experience of the state securities authorities has been that the first year of enforcement is one of

many applications for licenses and permits and of wholesale refusals, after which there is a decline in both the number of applications and the percentage of rejections.

In Pennsylvania, out of 1436 "dealers'" applications for registration ("dealers" including both issuers and persons selling for their own account securities issued by others) which were filed in the first year of the operation of the blue sky law, ending August 1, 1924, 761 registrations were in effect at the close of the period, while out of 1274 such applications in the succeeding twelve months, 754 registrations remained in effect upon August 1, 1925. It will be observed that although the applications diminished by 162 in the later period, the decrease in effective registrations was only 7 in number.

In Wisconsin, which inaugurated the licensing of dealers in 1919, the present number of dealers marketing low-grade securities aggregates only 50 per cent. of the total number in 1919, and the amount of money annually invested in their wares has decreased 75 per cent., while, on the other hand, the number of high-grade houses has increased. In 1919 there were "innumerable" applications from outside the state for approval of Class B (speculative) securities, but in the year ending June 30, 1924, only eight or ten. Similarly, the following table indicates the number of oil and mining companies applying in Wisconsin for authorization to sell their speculative securities for the first, second, third and sixth years of blue sky regulation:

	Oil companies	Mining companies
1919-1920	65	31
1920-1921	28	12
1921-1922	21	9
1922-1923	4	3

Relative to this decrease, the securities commission stated, in its report for 1922, that "it is fair to assume that the decrease is due chiefly to the improbability of obtaining permits."

The wholesome effect of blue sky laws is indicated also by a comparison of the raitos for successive years of applications for salesmen's licenses to their authorizations. In the twelve months ending August 1, 1924, there were received by the Pennsylvania commission 6469 applications for such licenses, of which 2807 registrations remained in effect at the close of the period. In the next twelve months 4202 applications were received, and of this

number, smaller by two thousand, 2915 registrations (or an increase of 108) were in effect on August 1, 1925.

The most drastic and rapid clean-up of fraud in the short history of blue sky regulation took place in Ohio in 1923, when the corrupt officials then holding office were replaced by the present administration. The chief of the securities division of the state has summarized the campaign as follows:

> "During the past two years (1923-24) the securities department has received and investigated 254 complaints of violations of the securities law. Hundreds of hearings have been called as a result of which hundreds of thousands of dollars have been restored to defrauded purchasers of stocks and bonds. Scores and scores of cases have been transmitted to prosecuting attorneys and numerous indictments have been returned by grand juries. During the January, 1924, grand jury term, ten indictments were returned alone for the selling of uncertified securities. The conviction of N. J. Grobez, of Sidney, and O. L. Brown, of Cleveland, because of the sale of uncertified securities, were two outstanding cases of illegal blue sky promotions."

In this reform movement the Ohio commission not only took action upon current applications for licenses and permits, but also called in for review the authorizations granted to securities vendors by the previous administration. The activities of the new incumbents are indicated in the following table:

Actions	Feb. 1, '23, to Sep. 10, '24 (19 mos.)	Sep. 10, '24, to Feb. 1, '25 (5 mos.)
Certificates refused	(3,118)	5
Certificates revoked	( )	14
Value of stock refused (par value)	($898,000,000)	$725,000
Value of stock revoked (par value)	( )	2,275,000
Value of stock refused (no par), shares	(24,000,000)	515,000
Value of stock revoked (no par), shares	( )	31,000
Stock certificated (par value)	$94,223,040	$6,500,000
Stock certificated (no par), shares	1,176,000	471,000

The first period covered by the above data was one of wholesale repudiation of previous vendors' authorizations, after which the situation improved. During the clean-up period the commission refused or revoked permission to sell stock aggregating in par value $898,000,000. The revoked permits had been granted by the previous administration, and comprised most of the amount. During the same period of nineteen months, the commission authorized new issues and approved holdover issues which, taken to-

gether, totalled $94,223,040. Holdover issues composed most of this amount. In other words, at the time the reform movement was inaugurated, the par value of illegitimate flotations circulating in Ohio was about ten times the par value of legitimate issues. In the second period, after the clean-up, the reputable flotations exceeded the rejected issues in par value by 200 per cent. The effective administration of the blue sky law explains the change in the situation, and the change is further evidenced by a decrease in the number of refusals and revocations of certificates from 3118 in the first period to 19 in the second period.

Almost all blue sky laws provide that prosecutions of violators may be originated by either the attorney generals of the states or the prosecuting attorneys of districts or counties. In most cases the local officers perform the duty, although in a few instances the attorney generals or securities commissions make a practice of assisting the district or county prosecutors by preparing the cases for trial. Jurisdiction over the person of the accused is held by the local attorneys' offices or the attorney generals' departments, and not by the securities commissions. All actions undertaken by these state officials are criminal prosecutions, although securities acts commonly provide in addition that defrauded investors may bring civil suits for damages, and plea violation of the statute as controlling evidence. However, few statistical data are available as to prosecutions under blue sky acts. The commissions of only ten states feel able to furnish any statistical information upon this point, and even these figures are merely suggestive approximations. Prosecutions are reported as follows:

	Period covered (Aug. to Aug.)	Approx. No. Prosecutions
Georgia	1920-1925	6
Idaho	1923-1925	6
Indiana	1920-1925	25
Michigan	1923-1925	400
Mississippi	1921-1925	4
New Hampshire	1924-1925	2
Pennsylvania	1924-1925	11
Vermont	1923-1925	0
Virginia	1920-1925	27
Wyoming	1919-1925	2

1. Except in New York, where, under a fraud act, injunctions are applied for in equity to prohibit the sale of securities believed fraudulent. These injunctions are unnecessary in states under regulatory statutes, as their place is taken by orders of the commissions. In this sense New Jersey and Maryland fraud acts are regulatory statutes, since the attorney generals of these states are empowered to issue stop-orders.

Few commissions record even the prosecutions undertaken by their offices, and in all states county or district attorneys prosecute independently. Michigan leads in prosecutions of blue sky swindlers, with some two hundred a year (of which the commission is responsible for about twenty-five), for the most part for selling without a license or for selling unaccepted securities. On the other hand, Indiana officials obtained only twenty-five indictments against violators of the securities act during the years 1920-1925 (to July 1), of which five resulted in convictions. Many violators of state blue sky laws simultaneously infringe upon the Federal postal laws, and in such cases the commissions usually waive their rights in favor of Federal prosecution. In Wisconsin, under a strictly administered regulatory act, there are at present "few barefaced violators of the law, and relatively few indictments and prosecutions," while in many states the securities commissions connive at "compounding" practices, which eliminate criminal proceedings.

It is worth noting, however, that the swindler is easily frightened away from a state by a threat of prosecution, even though the menace may be little more than a mere *ruse de guerre*. The Ohio commission, when apprised of a foreign mail swindler operating in that state, makes a practice of writing the knave, in purposefully vague language, that six Federal decisions have held such offenses to be indictable in Ohio. The swindler is prone to cease operations, although the fact is that, while he may be indicted in Ohio, he is in no danger of punishment so long as he personally remains beyond the borders of the state.

The practice of bonding securities dealers and agents has proven an effective method of driving questionable characters from the business, as these persons cannot survive the inquisitions of surety companies. In Ohio, by the Brown-Fouts amendment to the securities law (approved April 24, 1923), agents and dealers were compelled to furnish bonds, on which defrauded investors were empowered to sue for damages. The effects of the enforcement of the provision were immediate, as is indicated by the data:

	July 27, 1923	Aug. 8, 1923
Number of dealers registered	1,321	590
Number of agents registered	6,504	3,267

The elimination of fraud from the securities field has been furthered also by the assistance of reputable investment bankers,

Better Business Bureaus, and the officials of stock exchanges, who, by reason of their daily work, are brought into contact with objectionable issues and practices, almost immediately after their flotation or inauguration, and who either themselves take measures to check the evils or report the swindlers to the state authorities.

Current opinion, although expressed in diverse phraseology, is uniformly to the effect that blue sky laws have reduced swindling through the fraudulent flotation and sale of corporate obligations,[2] and the Pennsylvania securities commission, in its 1925 report, ironically acknowledges

> "the open and covert hostility of questionable dealers and disreputable agents and salesmen, as well as their legal representatives and associates, as a fair measure of the effectiveness of the securities act in curbing their false pretenses and frauds."

Further, the very existence of securities commissions, with their wide authority, has acted as a deterrent against many would-be swindlers, and the commissions' rejections of applications for permits and licenses have, beyond all question, blocked many promotions and transactions of a fraudulent character. There can be no doubt that actual service has been rendered by blue sky laws in the suppression and reduction of financial chicanery.

Official Laxness and Political Corruption in the Enforcement of Blue Sky Laws

The effective operation of blue sky laws has seldom been thwarted by intentional official laxness and political corruption and bribery. Three states only—Indiana, Ohio and Oregon—have produced national scandals of this nature, and evidence of isolated corruption is meager.

The conditions existing in Indiana during the years 1921-34 were brought to light in prosecutions conducted by the Federal government against J. H. Hawkins, in connection with his promotion and manipulation of the Hawkins Mortgage Company, and against the then governor of the state, W. T. McCray, in connec-

2. "Not much swindling in fraudulent promotions; plenty in sharp practices yet, that is, trading speculative securities for good ones;" "swindling through the promotion of new enterprises has been reduced 85 per cent. in Illinois;" "sporadic swindling in Alabama;" "swindling in fraudulent securities reduced from 50 to 75 per cent. in Arkansas;" "the law has done some good in Maine, although there is still plenty of funny business going on."

tion with the flotation of a fraudulent issue of preferred stock. In the Hawkins trial, held in the summer of 1925, it appeared from the testimony that Mr. Hawkins had promoted the Hawkins Mortgage Company in 1920, and until 1925 had sold the securities of the concern in Indiana. According to the company's ostensible plan of operation, funds were obtained through the sale of stocks and bonds and used to purchase mortgages placed upon rural and urban properties in the Middle West. The character of the mortgages purchased by the company, and the salaries and commissions paid in connection with the company's administration and the sale of its securities, resulted in its investigation by the securities commission of Indiana. The commission, however, was powerless to order the company to suspend operations, since it was exempt from the commission's jurisdiction by reason of a clause in the Indiana blue sky law (passed in 1920) which provided for exemption of "corporations organized or admitted to the state prior to August 1, 1921." In order to obtain jurisdiction over the Hawkins company and a number of other organizations, the commission introduced in the 1923 legislature a bill repealing the above-quoted exempting clause. This repealer was defeated in the legislature by lobbying and bribery, the Hawkins Mortgage Company paying the head of the lobby a salary of $600 per week, and spending a total of $40,000 to defeat the bill. Governor W. T. McCray, then occupying the gubernatorial chair, was not content to remain passive in the face of evident corruption, but personally engaged in the flotation of an issue of preferred stock based upon an agricultural enterprise, duly approved by the securities commission. Mr. McCray was acquitted in the Indiana courts on a charge of conversion of the proceeds of this security issue, but was later convicted in the Federal courts for using the mails to defraud and received a sentence to the Atlanta penitentiary.

The securities situation in Ohio from February 21, 1921, to September 10, 1922, was made public in the gubernatorial campaign of 1924, in which Mr. Harry L. Davis, governor during the above period, ran against Mr. Victor Dohaney, who had succeeded Mr. Davis as governor. Campaign documents published in 1924 in behalf of Mr. Dohaney revealed that during Mr. Davis's regime an inexcusable degree of official laxness had prevailed in the supervision of securities issues in Ohio. Promoters were commonly allowed to appropriate 51 per cent. of their companies' common stock issues in return for patents, promotional services and other

intangibles; schemes based upon the improvement of foreign real estate were liberally approved;[3] excessive commissions were allowed in connection with the distribution of securities; and certificates of authorization to sell securities were virtually permanent, since little, if any, attention was given to any change in the financial status of issuers which might impair the value of their securities and necessitate a revocation of their permits. Some 3000 certificates of authorization which were issued during Governor Davis's administration either lapsed or were revoked by the succeeding and more exacting administration.[4]

In Pennsylvania, the early career of the securities commission was marked by numerous clashes with "fixer" lawyers. These attorneys, representing companies whose merits were viewed askance by the Bureau of Securities, attempted to obtain registration for their clients by threatening political reprisals upon the commission in case their demands were not satisfied. The state officials, however, proved unamenable to these threats, and they were discontinued. The Pennsylvania commission was more seriously embarrassed by its early inability to explain the fairness of some of its actions to the Dauphin County Court, to which appeals lay from the commission's orders. In 1923-24, the first year of the law's operation, some twenty-seven appeals were taken to this court from decisions of the commission refusing registration to applicants desirous of selling corporate securities, and in nine of these appeals the court upheld the appellant companies and compelled their registration. The financial justice of the court's action is indicated by the fact that all nine of the companies so upheld are now defunct. During the second year of the law's operation, only four appeals were taken from the decisions of the bureau of securities

3. These schemes ostensibly provided for the improvement of some 325,000 acres of land, situated in all parts of the United States and Canada. The succeeding Dohaney administration pursued a different policy, certifying only two foreign land projects, involving in one case a colonization proposition in Mississippi where the land and buildings were sold at their actual cost, and in the other case a peach and pecan grove in Georgia where the deeds to the property passed through a trust company as trustee, thus insuring the purchaser a good title to the property, even though the issuer became insolvent.

4. Among the insolvent companies certified under the administration of Governor Davis were: Florida Farms and Industries; International Note & Mortgage Company (both subsidiaries of the R. L. Dollings Company); Cleveland Discount Company; Ohio Industrial Endowment Fund Company; Ohio Securities Company; Cleveland Avenue Finance Company; Great Southern Sulphur Company; Steel Realty Development Company; Steels Department Stores; Davis Sewing Machine Company (subsidiary of H. W. Dubiske Company), and the American Finance Company.

to the Dauphin County Court, and in none of these appeals was the commission reversed.[5]

Only a few other cases of official laxness and political corruption can be cited. At one time during the early period of blue sky enforcement in Kansas, applicants for permits to sell securities were put under some pressure to retain certain attorneys to advocate their causes before the commission; corrupt prosecuting attorneys are occasionally discovered, and the long career of oil swindlers in Texas was facilitated by the unexplained neglect of the legislature in failing to bring the guilty business trusts within the jurisdiction of the blue sky law. Even later, under the Governors Ferguson, officials of Texas displayed a complete lack of interest in letters addressed to them by prominent Texas citizens inquiring as to the current situation in blue sky legislation and enforcement.

It should be noted, hwevoer, that bribery and official corruption are to be sharply distinguished from the political pressure resulting from open campaigns carried on by organizations of securities dealers before legislatures and commissions in an effort to influence legislation, and also from the many public-spirited attempts to further a state's development through well-meant (although often unwise) insistence upon uneconomic exemptions and other undesirable statutory provisions.

The Operation of Blue Sky Laws as Affected by Inexperienced Officials

The prevalent unfamiliarity of commissions and more especially of prosecuting attorneys of the states with securities acts and their rights and duties thereunder is a serious burden upon the effective administration of blue sky laws. The frequent changes which take place in administrators[6] result in the removal from office of commissioners who have really learned their business and have become expert in the administration of the law, and the filling of the positions with inexperienced men, to the great injury of the legitimate interests whose business activities are hindered, and also to the detriment of the enforcement of the laws against fraud. This is

5. One of the most striking cases decided by the Dauphin County Court was the appeal of the Templar Motor Car Company, wherein the court handed down a decision approving the Pennsylvania registration of a company which five days before had been put out of existence by court proceedings in Ohio, in which state eleven persons were later convicted of violating the Ohio blue sky law in connection with the alleged reorganization scheme of the company.

6. There were ten such changes in the twelve months ending August, 1925.

the penalty which the administration of securities acts suffers under the conditions of shifting official personnel so common in our form of government.

Inexperienced prosecuting attorneys are almost equally detrimental to the efficient operation of blue sky laws. Although blue sky commissioners regulate and supervise the issuance of certain securities, they cannot apprehend or punish violators of the laws, further than to refuse permission to continue sales. The arrest, the indictment and the prosecution of the financial criminal lie in the hands of attorney generals and district attorneys, whose achievements in this kind of work have been unsatisfactory because of their inexperience with the securities acts and their operation, and the obscurities of the statutes themselves, for which the prosecutors are in no way to blame. A remedy for this situation has been suggested in the attachment to each commission, at least in the major investment states, of a corps of special prosecutors who might use the legal machinery of the state to arrest, indict and convict all securities swindlers. Although several objections are advanced,[7] this solution of a grave problem merits serious consideration. Meanwhile, the insertion in the securities acts of prescribed forms of indictment, as in the Alabama statute,[8] would alleviate the difficulties of the prosecuting attorneys and increase the enforceability of the securities acts.

Fraud laws have an advantage over regulatory acts in this respect because an attorney general upon assuming office has, with his staff, a better understanding of the duties, responsibilities, possibilities and procedure of his office than has an incoming securities commissioner of his position, due to the fact that there are many

7. "The county attorney exercises a restraining influence upon the over-enthusiastic commissioner. We must have checks and balances in this field as in others. The county attorney renders second judgment upon the seriousness of any offense."—Mr. A. G. Davis, of the Advertisers and Investors Protective League of Chicago. Deputy Commissioner Cooper of Ohio feels that if a commission were given power to prosecute its own cases, it would result in excessive centralization of power, and objection is also raised in connection with the expense of the plan.

8. "Many blue sky laws do not prescribe forms of indictment. Where this is true, prosecuting attorneys must draft them under common law pleading, a thing exceedingly difficult to do to have them stand the test of demurrers. I drew one set of indictments under our 1920 statute, to which counsel for the defense interposed 520 grounds of demurrer. The trial court sustained the demurrers, but on appeal to the supreme court (constitutional question involved) the trial court was reversed and the demurrers overruled. However, this illustrates the importance of prescribing forms of indictment."—Mr. Wm. C. Oates, secretary-examiner of the Securities Commission of Alabama.

competent and experienced attorneys outside the attorney general's office, whereas, in any state, very few men understand how to administer a regulatory blue sky law. An attorney general prior to his incumbency has usually studied the law for many years; a securities commissioner, previous to taking office, may have had little or no experience in the administration of blue sky legislation. The appointment usually comes, at best, as a reward for meritorious work in another field or in specialized investigation, and at worst to assist in maintaining a political machine.

In the future this situation may be somewhat altered, as the basic principles of blue sky laws become matters of more common agreement, and as more precedents are evolved. Until that time, however, every effort should be made, by all groups interested in a reasonable administration of these laws, to prevent securities commissionerships from being made a football of politics. In no other field is it more desirable that men should hold office during good behavior. The experience gained by a permanent commissioner renders him effective in detecting plausible cheats and at the same time efficient in smoothing the path of the legitimate dealer and honest promoter. Any administrative officer's best asset is his apperception—his instinctive appreciation of the proper procedure —and this is not developed in officers who come and go as the voting public sweeps from office one political party after another and the spoils system is practiced by all factions.

Variants in Fraudulent Securities Practices and Their Relation to Statutory Loopholes in Blue Sky Laws

Loopholes in blue sky statutes occur both because of expressed exemptions therein and because of failure of the acts to cover certain classes of securities and transactions, and these loopholes are most numerous in the strictly regulatory laws, which, because of their minuteness and attention to detail, are more narrowly interpreted by commissions, attorney generals and courts. This narrow interpretation has reduced certain commissions to the position of fact-finding bodies with little discretionary power, which, indeed, establishes a concrete situation and bolsters up a weak commission, but, on the other hand, enables it to evade responsibility and also often precludes equitable action by a strong commission.[9]

9. And after all, as maintained by Mr. A. G. Davis, Deputy Attorney General Keyes Winter of New York and many other authorities, "the commissioner is 95 per cent. of any blue sky law."

Almost every commission at some time has been compelled to stand helplessly aside while securities swindlers trafficked openly in obligations technically exempted from control, while failure to assert jurisdiction over certain classes of securities and transactions has merely resulted in the transfer of fraudulent operations from the regulated to the unregulated field. In Iowa, for instance, domestic corporations were exempt until 1921, and as such were channels of fraud. When this exemption was restricted to domestic corporations with capital stock totalling not over $50,000, the Peoples Grocery Stores Companies organized an exempt chain of such sister corporations. In Michigan, again, one-year debentures, which are exempt as commercial paper, are vehicles of fraud, while under section two, paragraph eleven of the Pennsylvania act, which allows reorganization of companies to take place without state supervision, swindlers have set up "reorganization" committees, "reorganized" defunct companies and levied assessments upon the stockholders.

Most blue sky laws exempt building and loan associations from regulation, and manipulation of the "shares" of these bodies has recently become prevalent. These organizations for many years successfully preserved their neighborhood characteristics and investment attributes, attaining an enviable reputation for conservatism and financial stability. Within the last few years, however, their exploitation has been undertaken by realty speculators, and, more illegally, by professional swindlers who occasionally organize them in order to accumulate a fund worth embezzling, but more commonly promote them in order to dispose of their shares for exorbitant selling commissions. In Indiana, which state attempted the partial regulation of building and loan associations by limiting salesmen's commissions to fifty cents per "share," clever financial rogues immediately reduced the face value of their associations' shares from one hundred dollars to five dollars, thus multiplying the legal selling commission twentyfold and thwarting the law.

In behalf of the local or "neighborhood" corporation, the Ohio act exempts new companies selling their stock without commissions and at a total expense of not over two per cent. of the par value, plus $500, and many issues thus exempt are sold by fraudulent promoters who seek their profit in excessively remunerated administrative positions in the issuing companies which they have created. Similar exemptions exist in other states. Again, issues approved by the utilities commission of one state are commonly

exempt in other states, and in illustration of frauds which occasionally occur under this class of exemptions, Michigan investors in one case lost large sums of money when they purchased the exempt securities of a worthless water company which had been certified by the public utilities commission of a western state. Virginia in 1918 defined certain securities as "speculative," including (1) those promising unusual profits, (2) those dependent for value upon future conditions, (3) those based upon mineral or unimproved lands, or upon intangible assets, (4) those in the sale of which selling commissions exceeding 7½ per cent. were paid, and (5) those based upon installment propositions, and the law required sellers of such obligations to obtain the approval of the state. Swindling proceeded, however, by means of schemes based upon lots and subdivisions of land, which were held not to be securities; by means of propositions exempt because offered to less than twenty-five persons; and by means of sales of securities issued by corporations exempt because their capital stock aggregated less than $25,000, although these companies might issue bonds in any amount. The Illinois law in 1923 was held not to cover fraudulent housing companies, which sold homes on the installment plan, title to pass at the completion of payments, but the securities commission of the state was able to expel the swindlers by means of injunctions obtained in courts of equity.

During the period of statutory evolution of blue sky laws, swindlers from time to time have found refuge in real estate promotions, silver fox farms, incorporated finance companies, bankers' shares, oil leases, business trusts, racehorse syndicates, partial payment plans and many other schemes which have been held to be outside the jurisdiction of the securities commissions either because specifically exempted by the blue sky law concerned or because the language of the act could not be extended to cover them.

"Compounding"

"Compounding" may be defined as an agreement, usually entered into at the request of the defrauded investor and frequently with the connivance of state officials, which is made between a successful swindler and his victimized securities purchaser and under the terms of which the rogue refunds the individual loss of the complaining dupe in return for immunity from criminal prosecution for his sale of a fraudulent issue of stocks or bonds. The

scheme is nationally practiced, and is condoned by the public, by many Better Business Bureaus and even by securities commissions.

The relatively few investors who, after the hasty purchase of worthless securities, report their losses to state authorities for the most part

> "regard both the securities departments and the prosecuting attorneys as collecting agencies. They will sign warrants for the prosecuting officials, but are willing to absent themselves at prosecutions if attorneys for defendants will repay their loss."[10]

In an Ohio case a promoter sold stock to persons who thus became minority stockholders in his company, after which he converted the property of the corporation, which consequently went into the hands of a receiver. The stockholders found that lack of assets precluded any civil remedy, and the swindler was arraigned by the Better Business Bureau under the Ohio blue sky law, since the sales had been made without certification of the securities. In order to avoid a jail sentence, the illegitimate promoter and embezzler consented to reimburse the complaining stockholders, the blue sky act thus functioning as a substitute for a civil suit for damages. The Chicago Advertisers and Investors Protective Bureau has by similar methods secured the refund of over one million dollars to purchasers of fraudulent securities. In its 1920 report the Wisconsin securities commission stated that

> "We keep in touch with the activities of brokers and companies after permits are issued. When it appears that securities have been sold by improper means, or by taking advantage of the purchaser, *we have required the money paid to be returned.* If circumstances indicate that the broker or agent is not a fit person to sell securities, we have suspended or cancelled his certificate."

The result of consistent compounding, however, is a complete subversion of the principles of justice. No benefit accrues to the great body of victimized investors through the indiscriminate distribution of a part of their losses to individual complaining witlings, the liberation of the jobbing trickster suborns the public welfare to the interests of the few, the morale of prosecuting offi-

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10. Mr. B. T. Hurwitz, former securities commissioner of Missouri, speaking before the National Association of Securities Commissioners at its 1924 convention.

cials deteriorates as half-completed fraud cases are *nolle prossed,* and, most important, the swindler learns that he may purchase immunity from punishment merely by setting aside a percentage of his accumulations as an "insurance" fund.[11]

Lack of Regulation of Partial Payment Houses by Blue Sky Laws

It is worth while to emphasize, as a defect in securities legislation, the present lack of supervision by state authorities over partial payment plans of various kinds, which are coming to play a prominent financial system, and to stress the necessity for stricter control over such projects. The subject has been brought before the public, in the first place, by the business failures of Slattery & Company, G. F. Redmond & Company, and other large partial payment brokerage houses, some of which were honestly mismanaged and others of which were fraudulently thrown into bankruptcy; and, in the second place, because of the widespread use of partial payment plans by swindlers in connection with financial propositions exempt under blue sky legislation.

The use of the partial payment or installment plan in connection with the sale of corporate securities has been rapidly increasing, and is now widely used by financially responsible investment houses as well as by those of less repute. Money received as payments on account under such subscription or installment plans is, in a sense, a trust fund belonging to the purchaser, and it ought to be so treated and given protection equal to that usually given a trust fund. Because of its immaturity, the installment payment business is hardly ready for the same supervision and regulation as the business of banking, but some method must be provided to protect the funds which thus accumulate in the hands of sellers of securities, and to prevent the losses which are due to bucketing and the failure of financially weak dealers and issuers selling under partial payment plans.

The suggestion has been made that protection may be found in requiring surety bonds of the sellers of securities on subscription

11. This practice is carried to an extreme in New York City, where "swindlers put aside from one-tenth to one-third of the money they get to reimburse persons who demand an adjustment."—Major Morgan K. Harris, head of the legal department of the Bureau for the Investigation of Financial Frauds. It should be stated, however, that both Deputy Attorney General Winter, the enforcing officer under the Martin act; and the New York Better Business Bureau are determined enemies of the practice of compounding.

contracts in sufficient sum to cover the maximum revolving partial payment trust funds, which requirement might be enforced upon qualification for sale of such investment contracts upon the licensing of dealers therein.[12] Some such action may well be taken by all states, particularly those where such contracts are not covered by any law; exempting from such legal provisions, by proper definitions, the ordinary margin transactions upon organized exchanges, if such operations appear to the legislators to merit special consideration.

It should be pointed out, so far as the investor is concerned, first, that a satisfactory variation of partial payment purchases exists in a purchase of securities for cash obtained through a bank loan collateralled by the securities and the retirement of the loan through a series of notes;[13] and secondly, that the purchase of a security unacceptable as bank collateral is unadvisable for the small investor, the usual employer of the partial payment plan.

The Enforcement of the Federal Postal Fraud Act

Enforcement of the fraud section of the Federal postal laws, which penalizes use of the mails to defraud, rests primarily with the solicitor of the Post Office and the Post Office inspectors, and ultimately with the Federal district attorneys and the United States courts.[14]

An absolute prerequisite for action by the postal authorities in fraud cases is a letter of complaint from a defrauded victim, which must be signed, as no notice is taken of anonymous complaints or

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12. Mr. G. Gale Gilbert, of the Illinois securities department, and others.

13. The desirability of this plan was manifested to the writer by an occurrence brought to his attention wherein an installment purchaser followed the described method with success, discovering afterwards that had he dealt directly with the very brokerage house employed by the bank to purchase the security, he would have lost his investment in the later failure of the broker.

14. The fraud section of the Federal postal laws is found in section 215, chapter VIII, of the Criminal Code of the United States, Act of March 4, 1909: "Section 215. Whoever, having devised or intending to devise any scheme or artifice to defraud, or for obtaining money or property by means of false or fraudulent pretenses, representations, or promises . . . shall, for the purpose of executing such scheme or artifice or attempting so to do, place, or cause to be placed, any letter, postal card, package, writing, circular, pamphlet or advertisement, in any . . . depositary for mail matter, . . . or shall take or receive such therefrom . . . or shall knowingly cause to be delivered by mail according to the direction thereon, any such letter . . . , shall be fined not more than one thousand dollars, or imprisoned not more than five years, or both."

information.[15] These letters, when received, are jacketed, together with any enclosed literature evidencing misrepresntation of the securities sold to the complainant, and are filed to await investigation by a Post Office inspector, who undertakes the task usually within two or three months and who works slowly and carefully. The inspector first examines the books of the suspected company[16] to discover the proportions and amounts in which the corporate receipts are disbursed through the channels of wages, materials, sales expense in connection with the disposal of securities and in other ways. Next the inspector searches for misrepresentations in the advertising literature or securities offers of the company, and also submits its physical properties to appraisal. He may find that the sales commissions and sales expense accounts connected with securities issued have absorbed an undue proportion of the company's receipts; or may detect the payment of unearned dividends, the over-valuation of assets, and misleading statements in the advertising or sales literature. In such case, he submits the information to the Federal district attorney for consideration, and the latter seeks an indictment of the swindling promoter or official before a Federal grand jury, if he believes that the evidence is sufficient to assure conviction. The refusal of the Federal district attorneys to prosecute doubtful cases results in the absolution of a large majority of the suspects, and the conviction of the remainder.

The Federal authorities co-operate with the state securities commissions to stamp out national frauds in cases where untrue statements have passed through the mails and resulted in loss. Where indictments are secured or can be secured before both state and Federal grand juries, states commonly waive their rights of action in favor of prosecution in Federal courts, where, once action is originated, the cases are carefully prepared by the Post Office inspectors, conviction is well assured, and sentences are heavy.

The most vigorous law-enforcing campaign ever conducted against postal swindlers was inaugurated in 1923 by Mr. H. S. New, when he was appointed postmaster general of the United

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15. Striking evidence of the ignorance (or fatalism) of financial "suckers" is found in the fact that postal authorities sometimes watch mail swindles carried to a successful completion without receiving one letter of complaint.

16. With the consent of the suspect, which seldom refuses the request of the inspector to be allowed access to its books, as this would bring a fraud order from the solicitor of the Post Office, which order would prohibit the delivery of its correspondence and hence cut off its revenue.

States. This campaign was aimed particularly at oil company promoters, who were then running riot in several states. Fraud orders were issued in eight months against 168 persons, of whom 117 were connected with oil stock organizations. Hundreds of other swindlers ceased to operate. In addition some 400 criminal cases were instituted against oil promoters in and about Fort Worth, Texas, and a large number of those indicted were convicted and sent to the penitentiary. The number of Post Office inspectors was increased and additional judges and prosecuting attorneys were used in the infected localities. In the state of Texas as a whole some 500 oil swindlers were investigated, virtually all of whom were guilty of fraud, but indictments were sought only in cases of assured conviction. The majority of the small operators escaped, either because conviction was thought impracticable or because they were amateur criminals who had seen the error of their ways and whom the government did not deem it desirable to punish.

Security swindlers have led the Federal government (like the state authorities) a stern chase in their search for *de jure* methods of defrauding the public. Prior to 1910 the basic plan was followed by these malefactors of disposing of promoters' stock acquired in exchange for worthless property or patent rights; after the courts placed this scheme in the category of fraud, the device was adopted of organizing a company, purchasing its stock for a nominal sum and reselling it to the public through misrepresentation at an advanced price. If this scheme is carefully executed, conviction of its perpetrators is exceedingly difficult even at the present time. When the business (common-law) trust was popularized, postal swindlers were among the first to take advantage of its possibilities, and 99 per cent. of the concerns encountered by the Federal authorities in their campaign against oil promoters in 1923 were operating under declarations of trust.[17] The government, however, triumphed against these organizations by charging that the declarations of trust were themselves a part of the artifices to defraud, which attitude was adopted by the courts.

While the Post Office Department does yeoman service in suppressing the interstate postal swindler, it labors under considerable difficulties. Prosecution depends upon indictment within three years after the posting of a letter in pursuit of fraud, and numerous consummated thefts go unpunished as uninvestigated complaints

17. Five out of five hundred were corporations.

pile up in the departmental offices under pressure of work.[18] Since 1920 the Federal courts have been crowded with violators of prohibition statutes and, while securities fraud cases wait their turn, the offenders go free on bail, the principal witnesses die or disappear and the cases fall to pieces. Federal district attorneys frequently are more interested in their private legal practice than in the duties of their office, and the burden of proof is upon the government to show intent to defraud. Only a small minority of the criminals are punished. If Congress would see its way clear to establish a special Post Office bureau devoted to the prosecution of mail frauds, and a special trial court modelled after the late commerce court, it would confer a boon upon the organizations now combating interstate postal swindlers. These modifications in the department of justice and the Federal courts are particularly desirable in view of the fact that enforcement of proposed Federal blue sky legislation will lie in their hands when if it is enacted and put into effect.

The Punishment of Financial Crime

The punishment of pecuniary crime, so completely relied upon to vanquish the financial swindler in foreign countries, is in modern America a dull and tarnished weapon. Obscure laws, incompetent prosecutors, congested courts and chaffering compromises with criminals have blunted its edge, and it lies in the shadow of an astounding public indifference to fraudulent peculation. If a bank is robbed of a few thousand dollars, the whole community is stirred, and all the forces of the county are marshalled to capture and punish the offender, but in the same locality a swindler may enter and take from the public many times the foregoing amount of money, and the theft is treated as a minor offense.[19]

A certain securities official has made the assertion that prevention of loss, and not punishment of crime, constitutes the goal of blue sky laws, reasoning that prosecution is a mere penalty, "just as is the arrest of a murderer by the police force. The main thing is

18. As in the case of the New Era Ore Reduction Company, a business trust of Pittsburgh and Philadelphia, capitalized at $15,000,000, which occasioned heavy losses to Pennsylvania and New York investors.

19. In Wisconsin, in the year ending June 30, 1921, only one jail sentence was imposed upon securities swindlers, and in other convictions in the same year the fines imposed were so small as to make the illegal sale of securities profitable to the person convicted.

to prevent the sale of the security in the first place."[20] This official implies, to use his own analogy, that the state should substitute for murder prosecutions a body of police sufficiently large to prevent the actual commission of homicide. In practice, however, the state both prevents and punishes crimes of violence, and similarly the state should both prevent and punish financial crime. The whole system of securities regulation in Canada, Great Britain, France and Belgium is based upon the principle of retributive justice, and a president of the New York Stock Exchange,[21] while emphasizing education of the investor as the foremost method of preventing financial swindles, states that in his opinion resort should also be had to the plan of "going after the crooked promoter and securities salesman, and punishing them swiftly, certainly and severely."

This is not to deprecate the value of blue sky legislation and its administration in preventing loss to investors. Such action merits commendation because it removes securities issues and transactions from the often inadequate test of corporate and criminal law, and, by submitting them to the more competent test of "fair, just and equitable" corporate finance, protects the public against the individual by preventing as many crimes and as much fraud as possible before anybody is injured. In addition, prevention of fraud is, in some respects, much easier than prosecutions under criminal statutes. Our fraud laws are too complex, and a perusal of the transcripts of record in fraud prosecutions reveals the shadowy legalistic realms into which the defendants' counsel, the presiding judge and the prosecuting attorney constantly wander in attempting to determine the innocence or guilt of some notorious financial criminal. Prevention may be accomplished by the refusal of a commissioner to approve a securities issue, and the swindler who under present conditions would with equanimity face a prosecution for fraud after a successful campaign usually feels compelled to respect the commission's rejection of his proposed issue, since sales in violation of the state's action are a *prima facie* infringement of the law and subject the vendor to its penalties, and this before his harvest has been reaped. But the only reason the securities swindler respects the action of the state commission is his belief that violations will result in punishment, and it cannot be too strongly em-

20. Mr. B. T. Hurwitz, former deputy commissioner of finance for Missouri, speaking before the National Association of Securities Commissioners in 1924.

21. Mr. E. H. H. Simmons.

phasized that prompt and certain penitentiary sentences of severity are a most efficient method of deterring the financial criminal from such violations.

The elimination of fraudulent securities from the field of American finance is the dominant purpose of blue sky laws and their administration. In summarizing the economic effects of the operation of these statutes upon fraudulent corporate issues, it may be said that the states have succeeded in considerably diminishing this evil, so far as intrastate swindles are concerned. The attainment of this goal has been hindered by official laxness and political corruption; by inexperienced officials, statutory loopholes, "compounding" and the difficulty of punishing criminals when discovered. Over interstate malefactors the states have little or no jurisdiction, which has resulted in the removal of fraud from one field to another.

VI

THE ECONOMIC DESIRABILITY OF BLUE SKY CONTROL OF SECURITIES

Conclusions have been drawn in the preceding chapters as to the economic effects of the administration of blue sky laws upon high-grade, speculative and fraudulent securities. Something may be said now concerning the desirability of these effects.

High-grade securities, either in the form of stocks or bonds, are issued alike by states and municipalities, by public utilities and established industrial and commercial corporations, in order to obtain fixed and working capital to further advance the program of society. The enforcement of blue sky laws, despite their exemptions and modifications, at present lays a considerable burden upon the distribution of these securities, and to this extent interferes with the flow of investment capital from the public to the recipient corporations. There can be no gainsaying the fact that this hampering effect is economically undesirable. On the other hand, blue sky laws have done much to diminish the volume of fraudulent and (to some extent) speculative securities, and hence have broadened the market for high-grade stocks and bonds.

Economic progress depends, however, not alone upon the replacement of worn-out capital and upon the expansion of established enterprises, but also upon constant experimentation with new industrial processes and upon the development of new natural resources. Further, decadent corporations in all lines of industry must be replaced by new companies with more vitality. The attainment of these objectives is the purpose of speculation and the flotation of speculative corporate obligations. As a group, blue sky laws require or permit state commissions to prohibit the issue of speculative securities, merely because, in the opinion of the commissions, the securities do not assure the investor a fair return upon his money, and to the extent of this activity, this economic experimentation is prevented and there results a retardation in the normal development of business.

Deductive reasoning leads to the conclusion that paternalistic surveillance of issues of stocks and bonds and the direction of public investment, if carried to the extreme, as by the capital issues committee during the world war, places upon the state the responsibility for determining the field and scope of national industrial

and commercial growth, and deprives the investing class of a part of its individual discretion.[1] On the other hand, if exercised in moderation the beneficial effects of such state guidance of investors somewhat counteracts its undesirable paternalistic tendencies, since a large amount of capital is thus made available for investment in higher-grade securities. On the whole, however, it may be concluded that this effect of the blue sky laws upon speculative securities is economically undesirable.

Another effect of blue sky enforcement upon speculative stocks and bonds is to imply a state endorsement of all such securities authorized to be sold. This is undesirable, since it misleads the investor as to the merits of his prospective purchase and substitutes in his mind a blind confidence in government for a more worthwhile alertness to his own best interests.

Finally, as regards the effects of blue sky laws upon speculative securities, it may be said that the operation of securities legislation has done something to raise the standards of corporate financing and administration, and in this way has eliminated a portion of the risk involved in any speculative commitments. This is entirely desirable, alike from the standpoint of the corporation concerned, the investor and society.

Turning to a discussion of the effects of the operation of blue sky laws upon fraudulent securities, it may be said that these effects, although not striking as regards magnitude, are economically desirable. Despite the defects incident to the laws and the difficulties in the path of their enforcement, a great number of fraudulent issues of corporate obligations have been prevented, many manipulative schemes have been intercepted or interrupted, and financial criminals have been punished.

Further, and perhaps more important, at least as yet, the publicity attendant upon the passage of securities legislation and its subsequent administration has tended to waken the lower strata of the investing and speculating public to the fact that a share of corporate common stock is not necessarily worth $100 in gold, and the income yield therefrom is not necessarily $6 annually.

1. It is improbable that American courts would allow such a tendency to develop to any great extent, as was brought out in the case of Alabama & N. O. Transportation vs. Doyle (210 Fed. 173, 1914), where the court explained that it would have supported the 1913 Michigan blue sky act if its regulations had borne any close relation to the subject of fraud; in fact, however, the act "did not simply protect the unwary citizen against fraudulent misleading, but it prevented an experienced investor from deliberately assisting an enterprise which he thought gave sufficient promise of gain to offset the risk of loss."

Evaluating blue sky laws according to their economic effects upon high-grade, speculative and fraudulent securities, respectively, the desirability of this control may be summarized as follows: First, control of high-grade securities by means of securities legislation is economically undesirable. Second, state control of speculative securities is desirable so far as standards of corporate financing and administration are raised, and perhaps because some additional capital is released for conservative investments, but on the whole undesirable because such control leads to paternalistic surveillance of the intrinsic merits of speculative ventures and thus hampers the industrial and commercial experimentation which is a necessity for social progress. Third, the control of fraudulent issues has proven beneficial because it has succeeded to some extent in reducing the social waste inherent in this type of financial exploitation.

Inasmuch as blue sky laws are thus in some ways economically desirable and in other ways undesirable, it may be asked whether fraud acts, specific approval statutes or dealer-licensing laws provide the best mechanism for regulating the American securities field. Assuming under each type of act the fair and efficient enforcement of its provisions, it is evident that fraud acts fail to solve the present blue sky problems because they make no provision for furnishing the potential investor with information upon offered securities.

Because they are able to check the commission of crime through preventive measures, specific-approval acts, when strictly enforced, may eliminate fraud by furnishing the investor with considerable information and by preventing and punishing financial crime. However, any increases in the efficiency of such laws must necessarily be obtained through closer scrutiny and more detailed investigation of securities issues offered to the public, and these activities in turn impose a greater burden upon legitimate securities issuers and, more particularly, upon reputable underwriters and other dealers. The specific-approval type of securities legislation, even when its rigors are mitigated by provisions for temporary approval or registration by notification, hardly succeeds in solving the problem of facilitating the marketing of legitimate securities.

Dealer-licensing blue sky acts, assuming their thorough enforcement by competent commissions, afford a basis for the prevention and punishment of financial jobbery, and at the same time leave the legitimate securities market free and unhampered, thus

satisfactorily solving the present blue sky problems with the exception of one, namely, the tendency of all blue sky laws to interfere with the issue and sale of low-grade speculative securities. This problem is fundamentally the most difficult in the field of securities legislation. In the pursuit of elimination of fraudulent corporate issues, state securities commissions must always come in contact with speculative flotations of all degrees of merit. The commissions may, and will, continually suppress many of these issues either because they are wrongly deemed fraudulent or because the officials believe them so obviously void of any chance of economic success that they should be suppressed to prevent social waste. The extent to which this suppression is carried by each commission can never be exactly measured, nor can the law ever exactly limit the commission in the matter. So long as state regulation of securities continues, all that can be done to assure the freedom of speculative securities is to make use of public officials who, in the first place, are expert at distinguishing fraudulent from merely speculative securities and who, in the second place, are desirous of according complete freedom to the latter class of issues.